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MEMORANDUM

December 13, 2004

TO: Edwin Quinones, U.S. EPA Region 6
Barbara Aldridge, U.S. EPA Region 6
Lydia Johnson, U.S. EPA Region 6

CC: Tracy Gipson, U.S. EPA Office of Site Remediation and Enforcement

FROM: Sarah Brennan and Joan K. Meyer, Industrial Economics, Inc.

SUBJECT: Updated Ability-to-Pay Analysis of Calabrian Corporation, Star Lake Canal Superfund Site, SSID # 06GY

Consistent with EPA's Superfund ability to pay guidance, we perform a two-phase analysis when assessing a potential responsible party's financial condition.[1] First, we assess the PRP's ability to finance the contribution with future available cash flow. Then, we analyze the PRP's assets and liabilities to determine its ability to fund the contribution through the sale of unnecessary assets or through additional debt.

Excess Cash Flow

Our current analysis is based on the internal financial statements submitted by Calabrian in December 2004. We note that these financial statements differ somewhat from the formal year-end financial statements reviewed by Pannell Kerr Foster. For example, pre-tax net income for 2003 is stated as $1,545,074 on the internal financial statements compared to $1,610,000 on the year-end financial statements reviewed by Pannell Kerr Foster.

According to the internal income statements (see **Exhibit A**), pre-tax net income decreased from $1.5 million in 2003 to $481,000 in the first eleven months of 2004. Unless the company's performance improves

[1] See "General Policy on Superfund Ability-to-Pay Determination," U.S. EPA, Office of Site Remediation Enforcement, September 30, 1997; and "Interim Guidance on the Ability to Pay and DeMinimus Revisions to CERCLA section 122(g) by the Small Business Liability Relief and Brownfields Revitalization Act," U.S. EPA, Office of Site Remediation Enforcement, May 17, 2004.

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dramatically in the last month of the year, which seems unlikely, there will have been a drop of roughly $1 million in net income. This decline appears to be driven by primarily by a 13 percent decrease in net sales, from $16.7 million to $14.5 million. Although cost of goods has not increased in absolute terms, it has increased as a percent of net sales, rising from 68.5 percent of net sales in 2003 to 71.3 percent of net sales in 2004. Looking at the same issue from a different perspective, net sales have dropped by $2.2 million while cost of goods only dropped by $1.1 million.

Calabrian's cash flow statement (see **Exhibit B**) begins with the company's after tax net income. This amount is adjusted for non-cash expenses (such as depreciation) and changes in balance sheet items that affect cash flow We have slightly modified the cash flow statements submitted by Calabrian in December 2004; most significantly, we have not deducted retained earnings from cash flow. This adjustment probably makes sense for purposes of the company's internal book-keeping and forecasting, but from EPA's perspective, retained earnings do not represent a cash expense

We also note that Calabrian deducts depreciation on disposed plant, property, and equipment from its internal cash flow statement. This adjustment seems unusual, as we would expect the loss in depreciation due to a property sale to be reflected by the line item "total gain/loss on asset disposal." In addition, the financial statements reviewed by Pannell Kerr Foster contain the same values for depreciation and total gain/loss on asset disposal as the internal financial statements submitted in December 2004, but do not contain the adjustment for depreciation on disposed plant, property, and equipment. As a result, we present a lower-bound range of ability-to-pay estimates that reflect this deduction and an upper-bound range that excludes this deduction. EPA may want to clarify this issue with Calabrian before making a final ability-to-pay determination.

If we assume that the deduction for the depreciation on disposed plant, property, and equipment is reasonable, and if we assume that Calabrian's business is not going to degenerate further, we believe that Calabrian can afford to pay between $122,000 and $397,000 per year over the next five years (see **Exhibit C**) This estimate is based upon after-tax cash flow in 2002 and 2004 and corresponds to a general rule-of-thumb that states that companies can generally afford to make a contribution worth 1 to 2 percent of sales (which would be $200,000 to $400,000 using revenues as of November 2004) If EPA would prefer a lump-sum payment, we can calculate the present value of this stream of cash over five years, using a discount rate of 10.9 percent. Using this method, we believe that Calabrian can afford to make a lump-sum payment of between $450,000 and $1.5 million.

If EPA discovers that the adjustment for depreciation on disposed plant, property, and equipment is only appropriate for internal purposes, then we would adjust our range upwards, to between $285,000 (2002 cash flow) and $840,000 (2004 cash flow) for annual payments, or $1.1 million to $3.2 million for a lump-sum payment. Both the lower-bound and upper-bound range of estimates are based on two implicit assumptions: that Calabrian will need to continue to invest around $1 million per year in plant, property, and equipment; and that Calabrian cannot trim expenses such as officers' compensation.

Ability to Incur Additional Debt

In addition to determining a company's ability-to-pay by examining the amount of excess cash it generates from core operations, we also review the firm's balance sheet for additional funding sources (see **Exhibit D**). We note that although Calabrian has experienced a significant drop in net income in the first eleven months of 2004, the company's balance sheet is still relatively strong.

According to the internal financial statements submitted by Calabrian in December 2004, the company's balance sheet is relatively healthy, despite the decline in net income. Between the end of 2003 and the end of November 2004, total assets have increased slightly, rising from $10.7 million to $10.9 million, outpacing the slight increase in total liabilities from $4 5 million to $4.6 million. As a result, total shareholder equity increased from $6.1 million to $6.3 million. The company's balance sheet has also improved significantly since December 2001: shareholder equity has increased by $2.1 million (a jump of about 50 percent), growing from $4.2 million in December 2001 to $6.3 million in November 2004.

Between December 2003 and November 2004, there was a slight decline in the ratio of current assets to current liabilities (from 1.49 to 1.41), suggesting that the company's finances have become somewhat less liquid. This change was driven primarily by the fact that although total assets increases, the company's current assets dropped from $5.1 million to $4.8 million. The ratio of current assets to current liabilities has increased substantially, however, since December 2001, when it was 1 15

In 2004, Calabrian continued to invest more in buildings and equipment than the amount depreciated. For example, the net value of its buildings and equipment increased by $136,000 in 2002, $475,000 in 2003, and $383,000 in the first eleven months of 2004. Calabrian also continued to decrease its long-term loans, which dropped by $545,000 in 2003 and by $250,000 in 2004. We note, however, that the company's deferred tax liability has increased by corresponding amounts, so that Calabrian's total long-term liabilities have remained relatively constant.

Summary

The new information submitted by Calabrian supports the company's assertions that business conditions have eroded in 2004. Specifically, the company's sales revenues have dropped by an estimated 13 percent while cost of goods has declined by only 10 percent. In other words, net sales have dropped by $2.2 million while cost of goods only dropped by $1.1 million. In sum, net income has dropped by roughly $1 million from December 2003 to November 2004.

Based on the new information, as long as the company's financial performance does not erode further, we believe that the company can likely afford to pay a Superfund contribution of between $450,000 and $1.5 million, which represents the present value of an annual payment ranging between $121,000 and $397,000 for five years, without suffering undue financial hardship. Calabrian's balance sheet does not suggest that the company can afford to take on additional debt to fund a larger Superfund contribution. The available information also does not reveal any discretionary assets. In conclusion, we note that our ability-to-pay assessment is based upon a conservative interpretation of the company's statement of cash flow. It may be worth pursuing further clarification of our question regarding the deduction of depreciation of disposed assets from the cash flow statement.

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Exhibit A: Income Statement
Calabrian Corporation

For the year ending:	12/31/2001	12/31/2002	12/31/2003	2004 10/31/2004	2004 11/30/2004
Gross sales	$ 16,336,411	$ 18,697,783	$ 23,015,223	$ 18,317,279	$ 20,014,000
Cost of sales	$ (3,444,381)	$ (4,810,160)	$ (6,305,193)	$ (5,133,631)	$ (5,547,000)
Net sales	**$ 12,892,030**	**$ 13,887,624**	**$ 16,710,029**	**$ 13,183,648**	**$ 14,467,000**
Direct Labor	$ 1,306,393	$ 1,346,450	$ 1,414,633	$ 1,193,726	
Benefits -- Direct Labor	$ 96,652	$ 103,877	$ 91,169	$ 80,370	
Maintenance Labor	$ 192,205	$ 237,661	$ 229,771	$ 196,422	
Supplies -- Direct Unit	$ 138,948	$ 148,444	$ 118,609	$ 107,350	
Supplies -- Direct Safety	$ 2,778	$ 8,988	$ 20,129	$ 4,402	
Supplies -- Direct Maintenance	$ 177,501	$ 264,747	$ 405,110	$ 345,480	
Supplies -- Process Chemicals	$ 56,209	$ 86,032	$ 150,165	$ 43,709	
Utilities -- Gas	$ 30,583	$ 28,311	$ 45,511	$ 48,512	
Utilities -- Electricity	$ 451,767	$ 351,517	$ 550,835	$ 523,833	
Utilities -- Water	$ 25,386	$ 16,645	$ 28,604	$ 29,949	
Equipment rentals -- equipment	$ 9,153	$ 3,636	$ 45,952	$ 71,523	
Equipment rentals -- railcar leases	$ 609,456	$ 972,964	$ 1,283,552	$ 1,142,071	
Equipment rentals -- frac tanks	$ 46,266	$ 18,246	$ 13,161	$ 5,517	
Equipment rentals -- service to cars	$ 1,734	$ 17,765	$ 11,844	$ 34,410	
Contract -- maintenance	$ 97,431	$ 99,207	$ 109,788	$ 78,350	
Contract -- consulting	$ -	$ -	$ 3,690	$ -	
Environmental -- direct unit	$ 19,629	$ 30,753	$ 25,036	$ 19,974	
Freight in	$ 169,420	$ 56,536	$ 15,526	$ 11,553	
Depreciation -- direct unit	$ 556,263	$ 677,302	$ 571,288	$ 502,317	$ 553,472
Cost of goods sold	$ 4,519,633	$ 4,193,470	$ 6,305,174	$ 4,886,528	
Cost of goods sold	**$ 8,507,408**	**$ 8,662,549**	**$ 11,439,544**	**$ 9,325,996**	**$ 10,311,472**
Gross profit	**$ 4,384,622**	**$ 5,225,074**	**$ 5,270,485**	**$ 3,857,652**	**$ 4,155,528**
Salaries	$ 1,137,898	$ 1,269,860	$ 1,351,189	$ 1,111,539	
Benefits -- Insurance/Pension	$ 84,503	$ 95,829	$ 127,449	$ 73,996	
Benefits -- Auto Allowance	$ 52,429	$ 63,574	$ 66,400	$ 52,678	
Employer Payroll Taxes	$ 85,816	$ 93,655	$ 104,930	$ 92,692	
Maintenance	$ 75,525	$ 62,880	$ 77,701	$ 82,524	
Direct Labor	$ 67,475	$ 62,353	$ 91,395	$ 77,653	
Direct Labor -- Employer Taxes	$ 6,460	$ 5,108	$ 10,990	$ 10,825	
Benefits -- Direct Labor, Ins/Pension	$ 51,123	$ 43,495	$ 43,583	$ 34,017	
General Expense	$ 1,645,851	$ 2,023,490	$ 1,843,392	$ 1,862,090	
Depreciation	$ 208,634	$ 210,416	$ 171,195	$ 165,657	$ 182,528
Total operating expenses	**$ 3,415,715**	**$ 3,930,660**	**$ 3,888,223**	**$ 3,563,671**	**$ 3,951,528**
Total operating income	**$ 968,907**	**$ 1,294,415**	**$ 1,382,262**	**$ 293,981**	**$ 204,000**
Other income	$ 44,818	$ 140,792	$ 229,556	$ 276,438	$ 327,000
Loss on disposal of assets	$ -	$ (216,432)	$ (2,433)	$ -	$ -
Interest expense -- General	$ (154,109)	$ (88,483)	$ (64,311)	$ (45,697)	$ (50,000)
Total other income (expense)	**$ (109,291)**	**$ (164,124)**	**$ 162,811**	**$ 230,741**	**$ 277,000**
Net income before tax	**$ 859,616**	**$ 1,130,291**	**$ 1,545,074**	**$ 524,722**	**$ 481,000**
Income tax	$ 12,260	$ 134,500	$ 431,225	$ 209,056	$ 193,000
Net income after tax	**$ 847,356**	**$ 995,791**	**$ 1,113,849**	**$ 315,666**	**$ 288,000**
Estimated CF (net income before tax + dep)	**$ 1,624,512**	**$ 2,018,009**	**$ 2,287,556**	**$ 1,192,696**	**$ 1,217,000**

Source Calabrian Corporation, Consolidated Financial Statements for the years ending December 31, 2001, 2002, 2003, and as of October 31 and November 30, 2004

Note The split of depreciation among cost of goods and other expenses in November 2004 is based upon the split in October 2004

Exhibit B: Cash Flow Statement
Calabrian Corporation

			2004	
As of:	12/31/2002	12/31/2003	10/31/2004	11/30/2004
Net income after tax	$ 995,791	$ 1,113,849	$ 315,666	$ 288,000
Depreciation expense	$ 887,718	$ 742,483	$ 667,974	$ 736,000
Loss on disposal of assets	$ 216,432	$ 2,433	$ (2,433)	$ (2,433)
Changes in short-term investments	$ (214,679)	$ 247,114	$ 103,244	$ 10,459
Changes in accounts receivable	$ (493,858)	$ (1,065,439)	$ 396,727	$ 204,785
Change in inventory	$ 221,521	$ (147,803)	$ 90,356	$ 56,889
Changes in prepaid expenses	$ (33,573)	$ (22,759)	$ (97,788)	$ (36,436)
Changes in accounts payable	$ (580,420)	$ 47,643	$ (114,813)	$ (233,477)
Changes in notes payable	$ (139,230)	$ 148,119	$ 116,805	$ 410,638
Changes in current maturities of long-term debt	$ -	$ 272,727	$ -	$ 273
Changes in other current liabilities	$ 339,195	$ 220,457	$ (291,106)	$ (163,842)
Cash flow from operating activities	**$ 1,198,897**	**$ 1,558,823**	**$ 1,184,632**	**$ 1,270,855**
Change in plant, property, and equipment	$ (859,162)	$ (1,113,644)	$ (1,078,437)	$ (675,517)
Depreciation on disposed plant, property, & equipment	$ (164,068)	$ (103,414)	$ -	$ (443,472)
Total gain/loss on asset disposal	$ (216,432)	$ (2,433)	$ 2,433	$ 2,433
Other assets (pension)	$ (5,626)	$ 89,436	$ (95,683)	$ (317)
Cash flow from investing activities	**$ (1,245,288)**	**$ (1,130,055)**	**$ (1,171,686)**	**$ (1,116,873)**
Long-term debt	$ 46,876	$ (263,437)	$ 149,083	$ 103,696
Minimum pension liability	$ (13,378)	$ 39,636	$ (54,357)	$ (54,000)
Cash flow from financing activities	**$ 33,498**	**$ (223,801)**	**$ 94,726**	**$ 49,696**
Net increase (decrease) in after-tax cash	$ (12,893)	$ 204,967	$ 107,671	$ 203,678
Net increase (decrease) in pre-tax cash	$ 121,607	$ 636,192	$ 316,727	$ 396,678
Net increase (decrease) in pre-tax cash, exc. deprec. on disposal of assets	$ 285,675	$ 739,606	$ 316,727	$ 840,150

Source: Calabrian Corporation, Consolidated Financial Statements for the years ending December 31, 2001, 2002, 2003, and as of October

Note: *Corrected calculation of these items to match change in balance sheet.

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Exhibit C: Estimates of Ability to Pay
Calabrian Corporation

Interest rate	10 9%
Time period (years)	5

	Lower bound			Upper-bound		
	Pre-tax cash (2002)	50% of pre-tax cash (Nov 2004)	Pre-tax cash (Nov 2004)	Pre-tax cash (2002)	50% of pre-tax cash (Nov 2004)	Pre-tax cash (Nov 2004)
Annual cash flow	$ 121,607	$ 198,339	$ 396,678	$ 285,675	$ 420,075	$ 840,150
Estimated lump-sum payment	$ 450,580	$ 734,888	$ 1,469,776	$ 1,058,485	$ 1,556,467	$ 3,112,934

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Exhibit D: Balance Sheet
Calabrian Corporation

				2004	
As of:	**12/31/2001**	**12/31/2002**	**12/31/2003**	**10/31/2004**	**11/30/2004**
Cash	$ 591,894	$ 806,572	$ 559,459	$ 456,215	$ 549,000
Accounts Receivable	$ 1,841,487	$ 2,335,346	$ 3,400,785	$ 3,004,057	$ 3,196,000
Inventories	$ 942,607	$ 721,086	$ 868,889	$ 778,533	$ 812,000
Prepaid expenses	$ 184,232	$ 217,805	$ 240,564	$ 338,351	$ 277,000
Deposits	$ 4,155	$ -	$ -	$ -	
Total current assets	**$ 3,564,375**	**$ 4,080,809**	**$ 5,069,696**	**$ 4,577,156**	**$ 4,834,000**
Land	$ 252,082	$ 252,082	$ 252,082	$ 252,082	$ 252,000
Buildings and equipment	$ 9,739,595	$ 10,598,757	$ 11,712,401	$ 12,790,838	$ 12,388,000
Buildings	$ 732,682	$ 860,424	$ 861,782	$ 1,057,782	
Machinery & Equipment	$ 6,980,756	$ 9,254,526	$ 10,219,401	$ 10,434,705	
Furniture & Fixtures	$ 177,422	$ 126,668	$ 47,208	$ 63,181	
Hardware & Software	$ 90,294	$ 67,800	$ 130,226	$ 136,926	
CIP	$ 1,758,441	$ 289,339	$ 453,784	$ 1,098,244	
Accumulated depreciation	$ (5,015,753)	$ (5,739,403)	$ (6,378,472)	$ (7,046,446)	$ (6,671,000)
Accumulated Depreciation, M&E and F&F	$ (4,988,239)	$ (5,733,335)	$ (6,373,395)	$ (7,040,088)	
Accumulated Depreciation, Corp. Equip.	$ -	$ -	$ (5,077)	$ (6,359)	
Accumulated Depreciation, Hardware	$ (27,514)	$ (6,068)	$ -	$ -	
Other assets	$ 83,810	$ 89,436	$ -	$ 95,683	$ 96,000
Pension -- Defined Benefits	$ 39,296	$ 36,184	$ -	$ 29,960	
Pension -- Prepaid Pension Cost	$ 44,514	$ 53,252	$ -	$ 65,723	
Total long-term assets	**$ 5,059,734**	**$ 5,200,872**	**$ 5,586,011**	**$ 6,092,156**	**$ 6,065,000**
TOTAL ASSETS	**$ 8,624,109**	**$ 9,281,680**	**$ 10,655,707**	**$ 10,669,312**	**$ 10,899,000**
Notes payable	$ 309,474	$ 170,244	$ 293,879	$ 335,450	$ 307,000
Notes payable -- Cofin*	$ 100,106	$ -	$ 136,553	$ 136,553	
Notes payable -- Wells Fargo	$ 93,144	$ -	$ -	$ -	
Notes payable -- Imperial AI	$ 116,225	$ 170,244	$ 157,326	$ 198,897	
Line of credit -- Wells Fargo	$ -	$ -	$ 24,483	$ 99,717	$ 422,000
Current Maturity of Long-term debt -- Wells Fargo	$ -	$ -	$ 272,727	$ 272,727	$ 273,000
Accounts payable -- Trade	$ 1,590,255	$ 1,009,834	$ 1,057,477	$ 942,664	$ 824,000
Accrued Expenses	$ 1,197,189	$ 1,536,385	$ 1,756,842	$ 1,465,736	$ 1,593,000
Total current liabilities	**$ 3,096,918**	**$ 2,716,462**	**$ 3,405,408**	**$ 3,116,294**	**$ 3,419,000**
Notes Payable -- Coffin	$ -	$ 119,741	$ -	$ -	$ -
Deferred Tax Liability	$ -	$ -	$ 401,758	$ 755,386	$ 755,000
Note payable -- Wells Fargo	$ 1,322,865	$ 1,250,000	$ 704,546	$ 500,000	$ 455,000
Total long-term liabilities	**$ 1,322,865**	**$ 1,369,741**	**$ 1,106,304**	**$ 1,255,386**	**$ 1,210,000**
TOTAL LIABILITIES	**$ 4,419,782**	**$ 4,086,203**	**$ 4,511,712**	**$ 4,371,680**	**$ 4,629,000**
Issued Common Stock	$ 8,000	$ 8,000	$ 8,000	$ 8,000	$ 8,000
Paid-in Capital	$ 444,000	$ 444,000	$ 444,000	$ 444,000	$ 444,000
Capital Genrl -- Redeemed Pfrd	$ 2,465,000	$ 2,465,000	$ 2,465,000	$ 2,465,000	$ 2,465,000
Minimum Pension Liability	$ (26,258)	$ (39,636)	$ -	$ (54,357)	$ (54,000)
Retained Earnings	$ 466,228	$ 1,322,322	$ 2,113,146	$ 3,119,324	$ 3,119,000
YTD Net Income	$ 847,356	$ 995,791	$ 1,113,849	$ 315,666	$ 288,000
TOTAL SHAREHOLDER EQUITY	**$ 4,204,326**	**$ 5,195,477**	**$ 6,143,995**	**$ 6,297,632**	**$ 6,270,000**
TOTAL LIABILITY AND SHAREHOLDER EQUITY	**$ 8,624,109**	**$ 9,281,680**	**$ 10,655,707**	**$ 10,669,312**	**$ 10,899,000**

Source Calabrian Corporation, Consolidated Financial Statements for the years ending December 31, 2001, 2002, 2003, and as of October 31 anc November 30, 2004.

Note· *This item is considered a short-term liability on the detailed monthly reports, but a short-term item on the summary monthly reports

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